

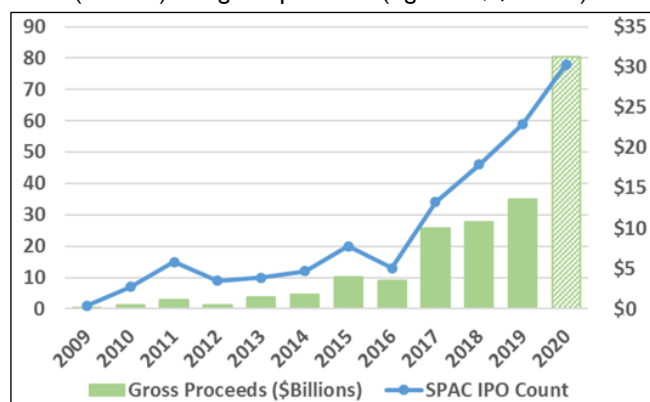
September 29, 2020

SPAC IPO: Background and Policy Issues

A special purpose acquisition company (SPAC) is a type of “blank-check” company that raises capital through initial public offerings (IPOs) with the intention to use the proceeds to acquire other companies at a later time. Unlike traditional IPOs, SPACs do not have commercial operations at the time of the IPO, explaining why they are referred to as blank-check or “shell” companies.

SPACs first appeared in the 1980s but have gained popularity in recent years, especially in 2020 during the Coronavirus Disease 2019 (COVID-19) pandemic (**Figure 1**). Between January 1, 2020, and August 21, 2020, U.S. SPAC IPOs raised a record \$31 billion through 78 transactions. SPAC IPOs reportedly outpaced traditional IPOs in July 2020 and August 2020. As SPACs increasingly take center stage, this In Focus explains how SPACs work and briefly reviews some policy implications.

Figure 1. SPAC IPO Transaction Summary
count (left axis) and gross proceeds (right axis, \$billions)



Source: CRS, based on data from Bill Gurley, Benchmark Capital.

Note: 2020 data as of August 21.

How Does a SPAC Work?

SPAC sponsors generally raise money in IPOs for future acquisitions of other private companies. Because finding acquisition targets can take time (typically two years), the cash is held in a trust while the sponsors look for a target. After the SPAC completes a merger, the previously privately held target company becomes a publicly listed operating company. This last step of creating the listed successor company is referred to as a “de-SPAC” transaction (**Figure 2**).

According to Securities and Exchange Commission (SEC) rules, a SPAC must keep 90% of its IPO gross proceeds in an escrow account through the date of acquisition. The SPAC should complete acquisitions reaching an aggregate fair market value of at least 80% of the value of the escrow account within 36 months. If the acquisitions cannot be

completed within that time, the SPAC must file for an extension or return the funds to investors. At the time of the de-SPAC transaction, the combined company also must meet stock exchange listing requirements for an operating company. The NASDAQ and the New York Stock Exchange are two common exchanges for SPAC listings.

Figure 2. How Does a SPAC Work?



Source: NASDAQ.

SPAC IPO Versus Traditional IPO

IPOs are common methods for companies to raise funds and gain trading liquidity for their equity stakes. A SPAC IPO and a traditional IPO have similarities. Both are public securities offerings in which company ownership shares are sold to the public for the first time. Both types of IPOs involve underwriting and SEC registration and disclosure processes and generally result in the listing of shares on stock exchanges. Through the IPO process, a privately held company becomes a public company, allowing the trading of its shares among broad investor pools made up of both institutional and retail (individual) investors. SPACs are different from traditional IPOs in other ways.

- **Investment Uncertainty.** SPAC investors place trust in the sponsors to identify acquisition targets. They do not know the details of a SPAC’s future investment at the time of its IPO. In contrast, investors in a traditional IPO purchase shares in a specific operating company.
- **Unit Structure.** SPACs often are sold in units, with each unit consisting of one share of common stock and some fraction of a warrant to purchase a certain volume of common stock in the future. After the SPAC IPO, investors can trade units, shares, and warrants separately.
- **Speed and Regulatory Scrutiny.** SPAC IPOs are faster and face less regulatory scrutiny, largely because SPAC IPOs do not yet have business operations. Their financial and business disclosures are substantially shorter than traditional IPOs.
- **De-SPAC Process.** After SPAC sponsors identify an acquisition target, shareholders have the right to choose either to stay with the deal or redeem their SPAC common stock for a pro rata share of the funds in escrow. The SEC requires SPACs to file material

disclosures (a so-called “super 8-K”) within four business days following the completion of a de-SPAC transaction. The super 8-K contains key financial and business information about the acquisition target.

- **Target Company Pricing.** The SPAC sponsor offers a fixed price for a target operating company’s equity shares. This pricing mechanism is different from a traditional IPO’s pricing, which is flexible and based on market demand for the company. Thus, SPAC targets may enjoy more certainty for funding and price than would be the case in traditional IPOs.
- **The Promote.** SPAC sponsors usually are compensated by *founder shares* that convert into public shares during a de-SPAC transaction; they also may receive warrants. This compensation, referred to as the *promote*, often represents as much as 20% of the value of a SPAC’s post-IPO common shares. The promote, which does not exist for traditional IPOs, could be *dilutive* to shareholders, meaning it can reduce shareholder payouts.

SPACs and the COVID-19 Environment

The COVID-19 pandemic has caused business closures, record unemployment, and a volatile stock market. The uncertainties and flexibilities embedded in the SPAC structure appear to address some of the unique needs of an uncertain environment.

In such an economic environment, investors face challenges in accurately assessing business prospects and future earnings. SPACs can help address this as the sponsors work as intermediaries to identify investment opportunities for investors. The SPAC structure affords sponsors the flexibility to receive funding first and seek optimum timing for listing target companies later. In 2020, SPACs have been relatively large and often led by well-known sponsors with long investment track records to gain investor trust.

Private target companies also can find SPACs attractive because SPACs provide price certainty and faster access to funding (relative to a traditional IPO), factors that are especially important during periods of market volatility. Some target companies also may find partnering with experienced SPAC sponsors potentially beneficial for enhancing company value.

Policy Issues

SPACs raise several policy issues for Congress and the SEC, including regulatory treatment, investor protection, exchange listing standards, and their perceived underperformance coupled with high sponsor fees.

Regulatory Treatment. As SPACs grew from a market niche to a popular alternative to traditional IPOs within a short period of time, questions arose regarding the equitable regulatory treatment of SPACs and traditional IPOs for certain similar activities. Many market participants view SPACs as an easier or “backdoor” entry into a public listing. SEC Chairman Jay Clayton said in a recent interview that the agency is critically evaluating SPAC disclosures, especially certain compensation disclosures.

Investor Protection. SPAC IPO investors purchase their shares without knowing the future target companies; if the investors do not like the proposed acquisition during the de-SPAC process, they can get their money back. Some are concerned that a lack of transparency and investor and regulatory scrutiny could be risky for investors. SPACs’ challenging past gives rise to this concern. Reportedly, they have been associated with fraud but recently have gained traction as more reputable institutions have embraced them.

Performance Records. In the past, SPACs had a reputation for underperforming traditional IPOs and other market benchmarks. Performance records, however, are mixed. Some industry research reportedly shows that, for the SPACs that completed de-SPAC transactions between 2015 and July 2020, their shares delivered an average loss of 18.8%. That compares with the average after-market return from traditional IPOs of 37.2% since 2015. University of Florida finance professor Jay Ritter calculates that from 2010 to 2017, SPACs underperformed the broader market by about 3% annually in the first three years after their IPOs. He attributes that underperformance to the period of time when the cash was in escrow accounts returning low interest rates while the market was rising. Other Bloomberg analysis shows that since 2017, SPACs have more closely tracked traditional IPO performance, especially for the larger SPAC IPOs. Each SPAC is different, and the industry is still evolving. As such, case-by-case analysis could also be important.

Incentive Structure. SPAC sponsors’ promote is typically high and not contingent upon meeting financial targets. Some believe that because of the pressure to construct a de-SPAC within a specified period of time, some SPAC sponsors, in order to book the promote, may be more interested in getting any deal done (rather than getting a good deal done). Additionally, the size of the SPACs’ promote draws concern for some. For example, Opendoor’s \$4.8 billion de-SPAC transaction, which included \$414 million in SPAC IPO proceeds, awarded the sponsors \$60 million in shares. The size of the typical sponsor compensation reduces investor payouts. There are also signs of the industry developing new incentive structures to attract investors. For example, the largest ever SPAC IPO, Pershing Square Tontine Holdings, paid a different sponsor fee. Instead of the typical 20% founder shares, it elected to tie the compensation to performance goals, mostly through warrants exercisable at 20% above the IPO price.

Exchange Listing Standards. Because of SPACs’ increased popularity in recent years, stock exchanges have tried to relax SPAC rules to attract listings. For example, the exchanges proposed reducing certain SPAC public shareholder thresholds, but the SEC rejected the proposals. Some argue that loosening SPAC listing standards might lower the bar for investor protection.

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IFI1655

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